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UNCLAS SECTION 01 OF 05 JAKARTA 000721

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DEPT FOR EAP/MTS AND EB/IFD/OMA
TREASURY FOR IA-SETH SEARLS
COMMERCE FOR 4430/BERLINGUETTE
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR FINEMAN
DEPARTMENT PASS EXIM BANK

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TAGS: EFIN EINV ECON PGOV ID
SUBJECT: INDONESIA TAKES FINAL STEP TO ROLL BACK BLANKET BANK GUARANTEE

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¶1. (SBU) Summary. Most analysts expect little short-term reaction from bank depositors when the Indonesian Deposit Insurance Corporation (LPS) takes the final step of reducing its deposit insurance coverage on March 22 to Rp 100 million ($11,050) per depositor per bank. While some large depositors are dividing their accounts inside a single bank, moving them to larger banks, or distributing money among different banks, there is no evidence to date of capital flight overseas. However, over the longer term, many questions remain about whether Indonesia has the regulatory structure to manage bank failures effectively. Relationships and the information flow between LPS and bank regulator Bank Indonesia are uncertain, Indonesia's banking elites remain as powerful as they were before the 1997-98 financial crisis, and the country's state-owned banks enjoy an implicit blanket guarantee by virtue of their presumed status as "systemic banks." A coordinating committee made up of representatives of BI, the Ministry of Finance (MOF) and LPS will attempt to set up a workable system for bank resolutions, but most parties expect the President would be forced to make the final decision if a large Indonesian bank were to fail. USAID technical advisors have played an important role in supporting LPS's structure, operations and outreach efforts from the outset. This cable uses an exchange rate of 9,050 per dollar. End Summary.

Crisis-Era Guarantee a Product of Duress

¶2. (U) The 1997-98 financial crisis led to a meltdown of Indonesia's banking sector, eventually costing the GOI more than $70 billion in recapitalization bonds and liquidation costs. The GOI liquidated 16 banks, and consolidated many more, and the number of commercial banks in Indonesia fell from 239 before the crisis to 138 at the end of 2003. As bank runs mounted in January 1998, the GOI instituted a blanket guarantee on third party liabilities of banks to restore public confidence in the banking system. Although the blanket guarantee was successful in quickly restoring public confidence in Indonesia's banks, it also created a large scale contingent liability for the GOI and introduced a new element of moral hazard into the banking system. Fortunately, as Indonesia's economic growth gathered momentum after 2000, only six small rural banks and a similar number of small private commercial banks failed through 2006, none of which presented systemic risk. In September 2004, Parliament enacted Law 24/2004 establishing the Indonesian Deposit

Insurance Corporation, know by its Indonesian acronym LPS. The law established LPS as an independent institution to protect depositors' funds and "actively participate in maintaining the stability of banking system" in cooperation with BI. LPS officially started operations in September 22, 2005 and began its phased rollback in March 2006.

Table 1: LPS Deposit Insurance

Date	Maximum Insured
Sept 2005 - March 2006	All deposits insured.
March 2006 - Sept 2006	Rp 5 billion ($550,000)
Sept 2006 - March 2007	Rp 1 billion ($110,000)
March 22, 2007 onward	Rp 100 million ($11,000)

¶3. (SBU) LPS is now heading into its fourth and final reduction of the level of coverage of its deposit guarantee. After 18 months of transition, LPS will guarantee deposits with value up to Rp 100 million ($11,050) effective March 22. Unlike in previous reductions of LPS's guarantee, reducing the level of per account coverage from Rp 1 billion to Rp 100 million will place a large amount of funds outside of the deposit insurance system, raising the possibility of depositor reaction. According to LPS data (Table 2) as of December 2006, almost 1.3 million Indonesian persons or institutions held account balances between Rp 100 million and Rp 1 billion. After March 22, account balances over Rp 100 billion will not fall under

the LPS deposit insurance. Previous reductions of the level of coverage of LPS's deposit guarantee affected far fewer accounts--only 23,000 in March 2006 and 116,000 in September 2006. In the case of a bank failure, the new LPS limit means that the LPS would cover directly the first Rp 100 million of each depositor account. Sums above the Rp 100 million level would only be paid after the resolution of the bank and liquidation of assets, depending on the circumstances.

Table 2: Bank Deposit Distribution
(as of December 2006)

Nominal Value Per Account	Deposit Accounts (in 000s)	%	Value of Deposits ($ billion)	%
Rp 0-50 million	78,904	96.9%	$20.9	14.6%
Rp 50-100 million	1,108	1.4	8.8	6.1
Rp 100 mill-1 bill	1,279	1.6	39.3	27.4
Rp 1-5 billion	116	0.1	24.9	17.4
Rp 5 billion+	23	0.0	49.6	34.5
Total:	81,431	100%	$143.4	100%

Source: LPS

¶4. (SBU) By luck or design, the GOI is taking the final step to reduce the blanket guarantee in the context of a strong operating environment for Indonesian banks. GDP growth accelerated in four consecutive quarters in 2006, and most analysts forecast 2007 growth to top 6 percent. Bank Indonesia has driven down its benchmark 30-day rate aggressively since May 2006 to 9% on March 6, the lowest since September 2005. Bank earnings are strong, loans are growing, and most banks have ample liquidity. In this context, LPS CEO Krishna Wijaya told us that there had not been any significant outflow of money out of the banking system, but that LPS still had concerns about capital flight offshore after the March 22 deadline.

¶5. (SBU) Jakarta bankers by and large confirm Wijaya's confidence in

the current stability of the banking system. "Banks are very liquid now. No one is screaming for deposits," a representative of Panin Bank, Indonesia's eighth largest bank told us. "The big depositors are investing in other instruments such as senior bank debt, government bonds or SBI." However, a representative in Jakarta of Bank Danamon, Indonesia's fifth largest bank said that, "The smaller banks pay higher rates, so there may be some additional flight to quality before or right after March 22 among the big depositors." The CEO of Permata Bank, Indonesia's ninth largest by assets, noted that the deposit situation is fairly stable. There is "good awareness among customers" and he is not seeing any money move out of his bank. "Money that wanted to move offshore would have done it by now. I expect most of the money will be staying in the banking system here."

If a Bank Fails: "Systemic" vs. "Non-Systemic"
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¶6. (SBU) Over the longer term, there is much less certainty about whether Indonesia's nascent deposit guarantee agency will be able to overcome the difficult institutional and political hurdles that have prevented effective bank resolution in the past. One structural issue facing the LPS is Law 24/2004's explicit differentiation between "systemic" and "non-systemic" banks. By writing this distinction into the law, Parliament signaled to depositors that the GOI will treat failed systemic banks differently, and presumably more generously, than non-systemic banks. The same provision opens a wide loophole for wealthy Indonesian bank owners to argue that, in the event of difficulties, their banks are "systemic" and therefore deserving of extra GOI support. For depositors, the distinction creates a bias against large depositors using small banks, possibly introducing instability into the system. LPS and BI will need to monitor how significant the move of large depositors away from small banks is in the coming months.

¶7. (SBU) On paper, the LPS's procedures for resolving systemic and

non-systemic banks are straightforward. According to the LPS law, for bank failures "with systemic impact," a coordinating committee made up of representatives of BI, MOF and LPS will review possible actions. For banks whose potential failure is non-systemic, LPS is to step in as soon as BI places the troubled bank under "special supervision." LPS will receive data from the bank and BI, and can request additional information if LPS needs it. If the bank fails, LPS has ten days to prioritize deposits, with "clear" deposits getting top priority. LPS is also tasked with working with the police and immigration authorities to assure that bank officials under investigation do not flee the country (as happened with the Bank Global President Irawan Salim in 2004, who fled after the bank collapsed and is still wanted by Interpol).

System Not Yet Tested:
Can Indonesia Resolve a Big Bank?

¶8. (SBU) If Indonesia's recent history is any guide, the LPS's actual response to a failed bank is likely to be messier. The 1997-98 failures of a number of large Indonesian banks saddled the state with large losses; Indonesia has only experienced small, insignificant bank failures since 2000. The relationship between the LPS, BI, and MOF, along with the continuing political power of many bank owners, leaves major unanswered questions about how smoothly bank resolutions are likely to proceed. Key issues include the following:

--Strengthening relationships, and information flow, between BI, LPS and the MOF: During crisis-era bank resolutions, BI and the Indonesian Bank Restructuring Agency (IBRA--LPS's predecessor organization) had a poor working relationship and shared little information. BI was reluctant to admit banks were failing, or pass them to IBRA, for fear that it would spark criticism of the effectiveness of BI's supervision. By the same token, IBRA was reluctant to accept responsibility for failing banks because it would require the agency to make large payout of GOI funds. This unproductive back-and-forth usually translated into a significantly

larger loss for the state. Strengthening coordination mechanisms and drafting clear guidelines and procedures for handling problem banks will be important for reducing these disincentives for cooperation. One favorable sign is that all LPS staff are still seconded from other agencies such as BI and MOF, a sign, according to one advisor, that BI wants to maintain a tight relationship with LPS.

--Clarity of "systemic bank" definition: As noted above, lack of clarity over the meaning of the term "systemic" could ignite political wrangling in the event a large or medium-sized bank faces troubles in the future. Will BI and MOF provide guidance promptly to LPS in the case of a systemic bank, or will decision making become tied up in political battles?

--Political interference by banking elites: Indonesia's domestic bankers remain an extremely influential group. During the crisis, in most instances they were able to inflict large losses on the Indonesian state while keeping their business groups intact. Although BI's bank supervision has improved markedly since the crisis, and law 24/2004 has set out a much clearer bank resolution framework, few Indonesian bank owners would allow LPS to liquidate their banks without a fight. Several recent events demonstrate the continuing political power of Indonesian bank owners. Owners of small banks have by and large ignored BI's pressure to merge with other banks as part of BI's Indonesian Bank Architecture program. In addition, only five years after IBRA took over Bank Internasional Indonesia (BII) at a loss of more than $1 billion, BI recently permitted BII's parent group, Sinar Mas, to purchase another domestic bank.

What if BNI Fails?

¶9. (SBU) Raden Pardede, the newly named Chairman of the Executive Forum of the Financial Sector Stability Forum told us that he is concerned that it will be difficult if a "systemic" bank fails. The Financial Sector Stability Forum is a GOI initiative to clarify roles and responsibilities of relevant agencies in case of another

financial sector crisis. Pardede said he was concerned, along with other financial sector watchers, about state-owned Bank Negara Indonesia (BNI). BNI is the country's third largest lender, with total assets of Rp 157.5 trillion ($17.4 billion) as of the third quarter 2006. It is suffering from high NPLs of 16.6%, or approximately Rp 12 trillion ($1.3 billion), more that triple BI's recommended maximum level of 5%. Unlike Bank Mandiri, BNI has not opened up its books or improved its management. It lacks transparency and Pardede said its financial condition is "worrisome." Pardede told us that if a bank the size of BNI were to fail, it would leave the GOI in a tricky situation. "Who will make the decision how to respond?" he said. "It will be tough for the MOF and BI to decide on a course of action. It may get kicked upstairs to the President."

U.S. Advisors Helping to Build LPS

¶10. (U) In June 2005, Parliament budgeted an initial Rp 4 trillion ($442 million) for LPS operations. LPS has not had to deal with any significant bank failures since its creation in 2005, though six very small rural banks are currently under liquidation. USAID has an ongoing project to assist LPS develop necessary operational policies, procedures and regulations to perform its deposit insurance activities, including the resolution of failing banks, payment of insured depositor claims, and the liquidation of failed bank assets. It has also supported LPS management with guidelines and information on best practices. The USAID assistance also includes outreach activities directed toward education the media, depositors and bankers about the insurance and claims payment function of the deposit insurer.

LPS Not Yet Ready for a Medium-Sized, Near-Term Failure

¶11. (SBU) For its early stage of life, LPS is relatively sound but needs to get stronger. Banks are complying with the requirement to pay a one-time membership contribution of 0.1% of paid-up capital and two insurance premiums a year of 0.1% of the average monthly balance of total deposits for each six-month period. However, LPS's equity and loss reserves as of late 2006 were $785 million, about the size of Indonesia's twenty-second largest bank, Bank Buana, with deposits of approximately Rp 7 trillion ($773 million). LPS would thus have a hard time with even a medium-sized bank failure in the near term, if it were a total collapse. (Note: The FDIC uses the Designated Reserve Ratio (the fund balance divided by the amount of insured deposits) with a target range of 1.15% - 1.5% of insured deposits.) The principal LPS balance sheet accounts are:

Table 3: LPS Principal Balance Sheet Accounts
December 2006

Type of Balance Sheet Account	Amount (Rp Trillion)	Amount $ million
Principal Asset:		
Investment portfolio	Rp 7.1	$784.5
Principal Liabilities:		
Equity	5.6	618.8
Contingent Loss Reserve	1.5	165.7

International Banks Grudgingly Accept LPS

¶12. (SBU) Foreign banks complain about LPS and say that it is just another cost of doing business in Indonesia, since they cannot rely on it for their wealthy customers. A large foreign bank in Indonesia commented that, "Most of our depositors are too big to be covered by LPS anyway. It is interesting that LPS is reducing the level of cover but not the basis for collecting the premium. We don't like having to pay LPS, when we get little benefit." Other foreign banks have made similar complaints. The GOI, however,

admits that it did not create LPS to provide a benefit to banking organizations: its purpose is to protect depositors and the government's balance sheet in the event of bank failures.

¶13. (SBU) The head of Southeast Asia for a large international bank noted that Indonesian deposit insurance is currently extremely inefficient. The premiums are not risk adjusted, but merely a function of size of deposits. An advisor to LPS noted that the first step of establishing LPS and getting the information about deposit insurance out to the public has been achieved. The current premium level was designed build the insurance fund to a sufficient level over a reasonable period of time without being unduly burdensome on the banking industry. Though this is not likely in the near term, LPS may eventually move to a more sophisticated, risk-based system, which will also reduce the burden on well-run banks, the advisor noted.

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